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Economic Report

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Will It Work?

Contrary to the belief expressed in some quarters, President Reagan's economic proposals are neither an outright repeal of the economic theories of John Maynard Keynes, nor are based entirely on a new, untested economic theory. Rather, they are an amalgam of old and new. As such, the President's proposals are not as risky as their critics assert. On the other hand, their likelihood of success may not be as great as the Administration hopes.

Keynes Resurrected

First and foremost in the President's plan is the need to balance the Federal government's budget. The President wants to do this in order to make the Federal Reserve's job of slowing money growth easier. That is —when the budget is in or near balance, the Federal Reserve can slow the rate of increase of money and credit without precipitating a credit squeeze. And as I will discuss below, slower money growth is the *sine qua non* for permanently reducing the rate of inflation.

As I pointed out in my November Economic Report, Keynes never directly attacked the classical notion that the Federal government's budget must be in balance. He was very much in favor of a balanced budget during periods in which the economy was growing. He advocated the use of a budget deficit to provide unemployment relief during periods in which the level of employment declined. However, he did not place great emphasis on the implications of a budget deficit beyond that of stimulating the economy. This is because he believed that deficits should not be used as a main tool of economic policy, and when they were they were to be used during periods of economic slack. The record of the postwar years shows that we have departed from Keynes's basic notion of running deficits in bad times and surpluses in good times. The last time we had a surplus in the Federal government's budget was in 1969; the time before that was 1960. In the 37 years since the end of the second World War, we have had deficits in 29.

The President has wisely recognized the implications of this spate of budget deficits. Not only has it forced the Federal Reserve to expand the supply of money and credit faster than the economy's ability to grow thus producing the basis for inflation, it has opened the door for the Federal government to intrude in many aspects of American life. The "buy now, pay later" budget system that characterized fiscal policy during most of the postwar era provided a boon to elected officials. Politicians began parading before the American people, promising everything without presenting a bill. There always seemed to be Federal money available to remedy whatever local ailment existed. Little wonder that we got into the economic mess that the President says we are in today. Thus, far from repealing Keynes, I would say that the President is adhering to one of Keynes's basic tenets — the use of budget deficits only to provide unemployment relief.

Monetarism Retained

Another aspect of the President's economic plan deals with monetary policy. The Administration would like the Federal Reserve to restrain money growth. Quoting from the President's State of the Union message: ". . . Our plan requires a national monetary policy which does not allow money growth to increase consistently faster than the growth of goods and services. In order to curb inflation, we need to slow the growth in our money supply. We will . . . vigorously pursue budget policies that'll make (the Federal Reserve's) job easier in reducing monetary growth. A successful program to achieve stable and moderate growth patterns in the money supply will keep both inflation and interest rates down and restore vigor to our financial institutions and markets."

There is nothing new and untested about this aspect of the President's plan. It takes into account what monetarists in particular and most economists in general have said for a long time: The basic, fundamental cause of inflation is too much money chasing too few goods. While individual prices change all the time, the overall price level can only go up if there is an excess

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amount of money and credit in circulation. Through the years, the Fed has had difficulty holding money growth to the growth of real goods and services. This is because of the influence of the Federal government and its policy of running budget deficits year after year. When the Federal government runs a deficit in its budget, it has to borrow to make up the difference, just like when you or I spend more than we take in. The Treasury, being the top-rated borrower, gets the first shot at the credit markets, and everybody else has to fall in line for the rest. As I observed above, there have been only eight times since the end of World War II in which the Treasury did not have to increase its borrowing from the financial markets, because there were eight surpluses in the budget. The rest of the times there were deficits.

Because the economy generates only a certain amount of loanable funds each year, the more the government borrows, the less is available for the private sector. This does not affect the top-rated corporations, which have access to funds from various sources. It does affect those at the bottom of the credit totem pole, where people like you and I might stand if we were buying a house, a car or any other item that requires credit. If the Federal Reserve stood idly by and did not replenish the money that Washington took out at the top, we would get closed out of the markets. In this situation, a money panic would ensue; interest rates would go sky-high; a credit crunch would develop followed by widespread business failures and bankruptcies.

Because the Fed was created to put an end to the repeated panics that caused the economy to have many severe downturns, and because the Fed, like the Supreme Court during Franklin Delano Roosevelt's era, reads the newspapers, it has felt constrained to provide additional liquidity to the financial markets so that the private sector can get what it wants after the public sector has financed its needs. This is why the Federal Reserve over the years has produced more money than the economy has goods. In turn, this is why we have the inflation rates that we do. Quoting from testimony that Paul A. Volcker, chairman of the Federal Reserve, gave last year before Congress, "There is little doubt that inflation can not persist in the long run unless it is accompanied by excessive expansion of money and credit." To this the monetarists would add: Control the quantity of money and you control inflation. The President is relying on the Fed to do just that, hence my statement that he is drawing from monetarism in the construction of his economic plan.

Supply Management "Discovered"

One of the greatest misconceptions perpetrated by the popular press is the notion that supply-side economics is new. Nothing could be further from the truth! Supply-side economics has its roots in no less a person than the classical economist, Adam Smith. Some 200 years ago, Smith warned that "high taxes, sometimes by diminishing the consumption of the taxed commodities and sometimes by encouraging smuggling, afford a smaller revenue to government than what might be drawn from more moderate taxes." Another classical economist, Jean Baptiste Say, in his Law of Markets, developed the notion that "supply creates its own demand." This theory holds that there can never be a serious and continuing shortage of purchasing power because production automatically returns to producers the wherewithal to buy the goods that are produced. If goods are left unsold, the classical economists argued, prices would fall to the level where all the items would eventually be sold. Moreover, the presence of unsold goods means that consumption is falling and savings are rising. The increase in savings, in turn, forces interest rates down and pushes investment up. Thus slack in consumption is automatically offset by investment. Classical theory, therefore, holds that the cyclical ups and downs of an economy are merely phases in the process of an adjustment that tends toward full employment.

The Great Depression, with its lack of demand amid plentiful supplies, scotched this theory. Prices did not fall very rapidly, and savings failed to generate offsetting investment. Keynes argued that a shortage of purchasing power could grow progressively worse as consumers cut back expenditures and business responded by curtailing production and investment. Indeed, the economy could settle at exceedingly depressed levels of economic activity and high unemployment. This led him to come up with the notion that the government could boost demand by spending more than it takes in. In other words—Keynes believed that demand creates its own supply.

This worked for a while—until deterrents developed and began to outweigh the incentives created by increased demand. One of these deterrents was inflation, caused by years of deficit spending. Besides boosting interest rates, inflation distorted corporate balance sheets and pushed individuals into higher tax brackets. Thus our tax code, which at one time was neutral in its effects on investment conditions, had become a significant deterrent by retarding capital formation. In subsequent years other deterrents appeared. Businessmen became concerned with energy availability, the threat of controls and ever-increasing rules and regulations.

Several years ago a study by the Joint Economic Committee of Congress recommended removing these deterrents in order to slow inflation without having to keep economic growth at a reduced level. Signed by conservatives and liberals, Republicans and Democrats alike, this unanimous report was remark-

able in its espousal of supply-side economics. Focusing on economic growth through the encouragement of investment and production, supply-side economists see such growth arising from a free response to the economic incentives of a free market. What is more, they believe that only the private sector can bring us sustained growth, thus there is a need to reduce the role of the public sector. This hardly seems like a new, untested economic theory.

Central to the supply-siders in the Reagan Administration is a change in tax rates. The aim of President Reagan's tax cut is to stimulate supplies—not demand, as has been the case in the past. High tax rates are seen as a roadblock to economic growth, as a disincentive to labor and capital. The Administration is trying to alter economic behavior by expanding the rewards for production. People will have the incentive to work harder if they can keep more of their incremental wages. This would be accomplished by people working overtime, withdrawing from tax shelters, foregoing consumption, rejecting leisure, selling gold, purchasing stocks, starting a business, taking extra training or otherwise accepting additional risk to earn more money. Not only are workers supposed to work harder for incremental dollars, but investors are supposed to limit their consumption in order to earn more dollars in the future. The tax cuts are supposed to reduce the rewards of sheltering income from taxes through investments in untaxable activities or through work "off the books."

To me, this aspect of supply-side economics makes a lot of sense. As I have said in the past, we have long paid too much attention to demand management and not enough to conditions that generate increased supplies. More supplies of goods and services will not only hold down inflation by matching demand, but the newer, more modern machinery and equipment that produces these goods, by increasing labor productivity, will further help slow the rate of inflation by providing an important offset to ongoing wage increases.

So far so good. These three aspects of the President's economic plan are neither new in nature nor unreasonable in objectives. If and as the budget is brought into balance, the Fed will be able to slow money growth without precipitating a credit squeeze and high interest rates. This will allow the rate of inflation to slow while at the same time removing a major deterrent to new investment in the form of high interest rates. With an assist from tax cuts aimed at generating increased supplies, this new investment will bring forth a faster rate of growth for the economy, more goods and services, more jobs and profits. It is when we get to the fourth part of the basis for the President's economic proposals that I encounter some difficulty. Interestingly, this is the "new" aspect that I referred to at the outset.

Rational Expectations: New and Risky

Simply stated, rational expectations theory suggests that individuals respond not only to specific stimulus connected with actual events, but also to expectations about the future effects of current events and policies. To me, this is separate from the other theories that the President has espoused. This is because entirely different results can be predicted if one has reason to believe that the public's attitude will change, for whatever the reason.

For example, tax cuts are normally viewed as contributing to additional expenditures by those receiving the tax relief. If these cuts were to be considered as a means toward reducing inflation, people would not spend more, they would save more, instead. As for investors, they would shift their preferences from precious metals, real estate and other tangible assets to such financial assets as corporate bonds and Treasury securities, if they thought inflation was set to recede. This portfolio shift would increase the supply of funds to the capital markets so that interest rates would not rise—even if the Federal Reserve maintained a very tight rein on money growth.

This increase in savings and investment is supposed to work in the following way: First, if people really believe that inflation will abate, they will be less tempted to buy goods simply to avoid paying higher prices later. At the same time, they (and others with investable funds) would view the current level of interest rates as a great investment opportunity, since less inflation usually brings with it lower interest rates. Thus they would buy government and corporate bonds either for their high rate of return, or with the hope of selling later with a capital gain. Either way, this theory goes, the cut in government revenues that would accompany a reduction in taxes would be financed largely out of savings and not by the Federal Reserve creating new money.

For this to work, two key elements must occur. The first is that an across-the-board tax cut must be enacted. This would allocate much of the benefits toward the upper income groups that pay the most taxes and have the greatest propensity to save. If the President's tax cut proposals are altered by Congress so that upper-income families don't get as much tax relief as the President would like, it is possible that, rather than savings, consumption might be stimulated, since the tax cuts would be going largely to those with the greatest tendency to consume.

More important is the notion that people have to believe that the government will be able to reduce inflation. It is here that I have even more difficulty, since there has been a general distrust of government in recent years. I guess this goes back to the Vietnam War, and the efforts by President Johnson to conceal

its scope from the American people while he was escalating it. In the 1970s people did not believe the government when it told them there was an energy crisis. People in the parched Northeast don't believe their local governments today when they tell them that water supplies are dangerously low. And, I would bet, a good many people don't believe that President Reagan will be able to balance the budget any more than his predecessor, Jimmy Carter, who "promised" the electorate in 1976 that he would balance the budget by 1980.

Plainly, if the people do not believe that the President's policies will slow inflation, then they will spend, not save, and will not provide the wherewithal for the increased budget deficit to be financed. In the absence of this increased savings, one of two things will happen: Either the Federal Reserve will stand fast, in which case interest rates will rise, choking off both investment and consumption, or if the Fed accommodates, then inflation expectations will worsen with the same negative effects.

To make matters worse, many people have grown to accept inflation as a way of life, and have made significant adjustments to it. These include such people as those whose incomes are linked to the consumer price index, people who have bought homes, people who borrow money and even people who lend money and save money. It would seem to me that the President has to recognize that he has to address this "inflation constituency" first, and convince people that inflation is something that should not be adjusted to, before he can get people to believe that the government is really going to slow its pace.

In the main, I think that if the President's program survives the inevitable alterations by Congress, it stands a pretty good chance of succeeding. However, its probability of success would be greater if less attention were paid to the relatively new and untested rational expectations theory and more emphasis were placed on the traditional, well known and respected theories of balancing the budget, slowing money growth and providing additional economic incentives for business investment. It has taken a long time for the public to become aware of inflation and especially the government's role in it. I don't think it is reasonable to assume that the public's attitude is going to change overnight—especially on the basis of words, as opposed to deeds.

It would seem to me that people will change their attitudes toward inflation and the expectation of inflation only when they see a fiscal policy that contains a credible schedule for reducing the budget deficit, and a monetary policy that follows up with progressively lower growth targets for the supply of money and credit. If and as this occurs, it will first show up in a reduction of interest rates in both the short- and the long-term markets, for financial market participants will then demand less of an inflation premium for commitments of funds. At this point, it would be safe for the Administration to ask the Congress to pass its program of across-the-board tax cuts. For only then will there be a chance that people will save the proportion of the tax cut that its proponents hope for, in order to prevent the resulting increased budget deficit from forcing either interest rates or the rate of inflation higher. H

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